

TREASURY - GENERAL

STATE INVESTMENT COUNCIL Absolute Return Strategy Investments

Proposed New Rules: N.J.A.C. 17:16-100

Authorized By: State Investment Council, Peter A. Langerman, Director,
Division of Investment

Authority: N.J.S.A. 52:18A-91

Calendar Reference: See Summary below for explanation of exception to calendar requirement.

Proposal Number: PRN 2005-71

Submit comments by April 23, 2005 to:

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The agency proposal follows:

Summary

The proposed new rules establish absolute return strategy investments as an investable asset class for five New Jersey pension funds (Police and Firemen's Retirement System; Public Employees' Retirement System; State Police Retirement System; Teachers' Pension and Annuity Fund; and Judicial Retirement System of New Jersey) under management by the Division of Investment. Absolute return strategy investments, as defined in the proposed new rules, mean investment strategies with the goal of achieving positive returns with a degree of independence from movements in financial markets and independent of traditional performance benchmarks such as the S&P 1500 Index. Several types of subcategories would be permissible: traditionally low volatility funds (for example invest in arbitrage opportunities with low overall net market exposure); equity long/short funds (for example hold a combination of long and short positions in publicly traded equities, with a net market exposure less than that of the

overall equity markets); and opportunistic funds (for example, invest in speculative opportunities with high net market exposure across varied markets). The assets of the eligible pension and annuity group funds could be invested in the following way: funds-of-funds, separate accounts and direct investments. The pension funds' commingled shares of absolute return strategy investments would be held in the newly proposed Common Pension Fund E, which is the common fund to be established by N.J.A.C. 17:16-69, proposed elsewhere in this issue of the New Jersey Register.

For any of the pension and annuity group funds investing in Common Pension Fund E, certain limits will apply for each of the following subcategories – low volatility funds (no more than two percent of the market value of any pension fund's assets); equity long/short funds (no more than three percent of the market value of any pension fund's assets); and opportunistic funds (no more than 1.5 percent of the market value of any pension fund's assets). Certain limits will apply for assets directly invested in any individual fund – low volatility funds (no more than .2 percent of the market value of any pension fund's assets); equity long/short funds (no more than .3 percent of the market value of any pension fund's assets); and opportunistic funds (no more than .15 percent of the market value of any pension fund's assets). An overall limitation is set at five percent of the aggregate market value of all assets of any of the eligible pension funds, and the State Investment Council shall be notified at a regularly scheduled meeting if the market value exceeds five percent; however, the Division may be granted a six-month grace period in which to reduce the level of participation below the five percent level, with an allowance for additional four-month extensions, as approved by the Council.

Because the Division is providing a 60-day comment period on this notice of proposal, this notice is exempt from the rulemaking calendar requirement pursuant to N.J.A.C. 1:30-3.3(a)5.

Social Impact

The proposed new rules are intended to expand the asset classes in which the State's pension funds can be invested and it is not anticipated that any actual social impact from the proposed new rules will occur.

Economic Impact

The proposed new rules will facilitate investment diversification, which based upon historical experience, should result in a reduction of total portfolio risk for the State's pension funds while offering an opportunity for improved rates of return over time. Therefore, it is not anticipated that the rules will have a negative economic impact; rather, the potential for improved returns should bode favorably for the State's taxpayers by reducing the level of State and municipal contributions over the long term.

Federal Standards Statement

A Federal standards analysis is not required because the investment policy rules of the Division of Investment are under the auspices of the State Investment Council, and are not subject to any Federal requirements or standards.

Jobs Impact

The State Investment Council and the Division of Investment do not believe that any jobs will be lost by virtue of the proposed new rules. Rather, the expectation is that there will be a creation of jobs within the Division of Investment to assist with the implementation and monitoring of this proposed investment program.

Agriculture Industry Impact

The proposed new rules shall have no impact on the agriculture industry.

Regulatory Flexibility Statement

A regulatory flexibility analysis is not required, since the proposed new rules impose no requirements on small businesses as the term is defined in N.J.S.A. 52:14B-16 et seq., but regulate only the Director of the Division of Investment.

Smart Growth Impact

The proposed new rules are not anticipated to have an impact on the achievement of smart growth and implementation of the State Development and Redevelopment Plan.

Full text of the proposed new rules follows:

SUBCHAPTER 100. ABSOLUTE RETURN STRATEGY INVESTMENTS

17:16-100.1 Definitions

The following words and terms, as used in this subchapter, shall have the following meanings, unless the context clearly indicates otherwise:

“Absolute return strategy” means investment strategies with the goal of achieving positive returns with a degree of independence from movements in financial markets and independent of traditional performance benchmarks such as the S&P 1500 Index.

“Equity long/short funds” means a fund holding a combination of long and short positions in publicly traded equities, with a net market exposure less than that of the overall equity market.

“Funds-of-funds” means a fund set up to distribute investments among a selection of fund managers, who in turn invest the capital directly.

“Low volatility funds” means funds investing in arbitrage opportunities with low overall net market exposure, equity market neutral, fixed income arbitrage, convertible bond arbitrage, risk arbitrage, merger arbitrage, distressed debt and other event-driven strategies.

“Opportunistic funds” means funds investing in speculative opportunities with high net market exposure across varied markets.

“Separate accounts” means ownership is segregated and kept in the investor’s name.

17:16-100.2 Permissible investments

(a) Subject to the limitations contained in this subchapter, the Director may invest in absolute return strategy investments through funds-of-funds, separate accounts and direct investments in individual funds (all generally through limited partnerships) in any of the following ways:

1. Participation in low volatility funds is permissible provided:
 - i. No more than two percent of the market value of the assets of any pension and annuity group fund investing in Common Fund E may be invested in this subcategory; and
 - ii. No more than .2 percent of the market value of the assets of any pension and annuity group fund investing in Common Fund E may be invested directly in any individual fund.

2. Participation in equity long/short funds is permissible provided:
 - i. No more than three percent of the market value of the assets of any pension and annuity group fund investing in Common Fund E may be invested in this subcategory; and
 - ii. No more than .3 percent of the market value of the assets of any pension and annuity group fund investing in Common Fund E may be invested directly in any individual fund.
3. Participation in opportunistic funds is permissible provided:
 - i. No more than 1.5 percent of the market value of the assets of any pension and annuity group fund investing in Common Fund E may be invested in this subcategory; and
 - ii. No more than .15 percent of the market value of the assets of any pension and annuity group fund investing in Common Fund E may be invested directly in any individual fund.

17:16-100.3 Applicable funds

- (a) Applicable funds are as follows:
 1. Police and Firemen's Retirement System;
 2. Public Employees' Retirement System;
 3. State Police Retirement System;
 4. Teachers' Pension and Annuity Fund; and
 5. Judicial Retirement System of New Jersey.

17:16-100.4 Limitations

(a) The aggregate market value of absolute return strategy investments under this subchapter, for any eligible pension fund, shall not exceed five percent of the market value of all assets of such pension fund.

(b) If the market value exceeds five percent, then the State Investment Council shall be notified at a regularly scheduled meeting of the Council. The Division may be granted a six-month period of grace to reduce the level of participation of the fund below the five percent level, except that the period of grace may be extended for additional four-month periods with the approval of the Council.

17:16-100.5 Legal papers

(a) Prior to any commitment to purchase obligations of the type described in this subchapter, the Director shall have obtained:

1. A prospectus or offering documentation describing the investment;
2. A purchase agreement, if applicable; and
3. Such other documents or opinions which the Attorney General may require.